

Impact of Monetary Policy Transmission Mechanisms on Capital Market Liquidity in Nigeria (2006-2020)

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Abstract: This study examined the impacts of monetary policy transmission mechanisms on the liquidity of Nigerian capital market from 2006-2020. The required data were sourced from Central Bank of Nigeria (CBN) statistical bulletin. Capital market liquidity is the dependent variable while the independent variables are; treasury bill rate, savings rate, net domestic credit, exchange rate and inflation rate. The Ordinary Least Square multiple regressions with econometric view were used as data analysis techniques. The study found that monetary policy transmission mechanism does not have significant impact on the liquidity of the capital market as against the findings of Akani and Imegi (2017). Also, all the channels of monetary policy transmission mechanisms have positive relationship with capital market liquidity except exchange rate. It therefore recommends that exchange rate should be worked upon so as to enhance the liquidity of Nigerian capital market in view of its negative impact on the capital market liquidity

Keyword: monetary policy transmission mechanism, liquidity of capital market, treasury bill rate, savings rate, net domestic credit, exchange rate and inflation rate.

I. INTRODUCTION

Due to structural and economic changes and subsequent transitions to new policy regimes, study of monetary transmission mechanisms in emerging economies has gained significant significance since the beginning of the 1990s. These economies, on the other hand, have distinct characteristics from those of developed countries. According to Akani and Imegi (2017), monetary policy refers to the monetary authority's stance on monetary issues. It deals with financial institution controls, aggressive purchases and sales of paper assets to influence improvements in the money supply and interest rate maintenance. Monetary policy has existed in Nigeria since the founding of the Central Bank in 1959, and the mechanism for implementing it has undergone many changes. Direct monetary management was the key strategy of monetary policy implementation during this period, with a later transition to an indirect (market-based) approach in 1993. Direct monetary regulation was emphasized in the direct method (1974-1992).

The various intermediate channels by which changes in the nominal money stock or short-term interest rates influence macroeconomic aggregates are referred to as the monetary policy transmission mechanism (Akani, Okonkwo and Ibenta, 2016). The interest rate channel, asset price channel,

and exchange rate channel are all transmission mechanisms. The interest rate channel discusses how expansionary monetary policy impacts business investment by lowering long-term interest rates. The asset price channel claims that expansionary monetary policy leads to higher equity prices, which makes investment more appealing and raises aggregate demand, while the exchange rate channel claims that expansionary monetary policy lowers the domestic real interest rate and causes a real depreciation of the domestic currency due to the foreign interest parity condition, which leads to higher aggregate demand. Akani and colleagues (2016). The macroeconomic environment and structural economic conditions, the extent of development of capital markets, the health of and extent of development within the financial system, as well as the major monetary policy instruments used by the nation, all influence monetary transmission channels. "An efficient and reliable transmission mechanism of monetary policy can only be ensured in an economically stable and sound environment characterized by a competitive banking system," according to Sanusi (2009).

Liquidity refers to an asset's capacity to be turned into cash at a moment's notice without losing value. Central bank liquidity refers to reserves kept by financial institutions at the central bank, market liquidity refers to the ability to buy and sell assets without causing undue price volatility, and financing liquidity refers to the ability to raise cash in the market through collateralized loans, asset sales, or borrowing. Liquidity of the stock market is also one of the regulatory authorities' top priorities in the market. This is because a liquid capital market allows potential investors to change their investments rapidly and cheaply, lowering the risk of their investment and allowing them to invest in more profitable ventures.

Statement of the Problem

The monetary policy transmission mechanism as a pathway through which monetary policy choices affect the general economy should be established for any economy to go in the right direction on the path of development. Despite recent efforts by the Central Bank of Nigeria (CBN) and monetary policymakers to define the most successful transmission mechanism, the economy has failed to react favorably, and the monetary policy transmission mechanism has remained

uncertain Extant studies also show that the interaction between capital market liquidity and monetary policy will only work in developed financial markets where monetary policy is well managed and its financial market objectives are met, as opposed to developing countries' financial markets, such as Nigeria's, where the financial market is developing and monetary policy is characterized by uncertainty. In addition, there are only a few studies of note on the effect of monetary policy transmission mechanisms on capital market liquidity. The few ones that exist did not consider the all the five channels as indicated in this study such as Akani and Imegi (2017). Hence, this study intends to examine the impact of monetary policy transmission mechanisms on capital market liquidity in Nigeria from 2006 to 2020.

Objectives of the Study

To identify the descriptive characteristics of the channels of monetary policy transmission mechanisms.

To examine the effect of monetary policy transmission mechanisms on money market liquidity.

Hypothesis of the Study

Ho₁: Monetary policy transmission mechanisms do not have impact on capital market liquidity

Significance of the Study

This study is relevant mostly because of the abundant benefits that can be derived from it. It will help policymakers to formulate appropriate policies by determining the right channels and instruments of monetary policy transmission mechanisms to deploy in stabilizing the Nigeria economy. Thus, research on the impact of monetary policy transmission mechanisms on the capital market liquidity can serve as a distinguishing case study revealing the ease and flexibility with which financial market participants catches up with forerunners by increasing their participation on the global stage.

Scope of the Study

Financial market is composed of the money market, capital market, commodity market, derivatives market, futures market, insurance market as well as foreign exchange market (World Finance, 2015). However, this study is focused on capital markets. This is because the consequence of the financial crises was more evident in the performance of capital markets (Olokoyo *et al*, 2014). Also, the capital markets are the most common form of financial market in Nigeria. The periods to covered are between 2006 and 2020. The rationale for the time frame is to cover the era of major global financial crisis of 2008 which caused devastating and contagious effects and implications on all economies of the world. Its impact in Nigeria is evident in the performance of the NSE and the financial system as well as in the real sector (Olopa *et al*, 2011).

II. LITERATURE REVIEW

Conceptual Review

The objectives of monetary policy

In recent years, many have argued that central banks should emphasize price stability as a single order priorities, such as growth or employment, are not taken into account when determining monetary policy. The desire to restrict monetary policy's objectives in this way stems from the near-universal agreement among economists and policymakers that monetary policy cannot affect the economy's long-term growth. Efforts to boost growth above its potential rate, in this view, simply lead to higher inflation; as a result, monetary policy can only moderate short-term fluctuations in production. Many economists doubt that discretionary monetary policy can effectively reduce economic volatility. It's difficult to time policy decisions precisely enough to stabilize market cycles because of lags in understanding business cycle turns and subsequent lags in the economy's reaction to changes in monetary policy (Kamin *et al.*, 1998). Furthermore, while many central banks may continue to try to stabilize production in practice, they find that having their public mandate limited to price stability reduces their susceptibility to political pressure for expansionary policy.

Monetary Policy Transmission Mechanism

The monetary authority's stance on monetary (money) matters is referred to as monetary policy. It deals with financial institution controls, aggressive purchases and sales of paper assets to influence shifts in the money supply, and interest rate maintenance (Jhingan, 2005). Changes in the money supply or other aggregates, according to the classical theory of monetary policy, will function through certain intermediate variables, through which some results will be transmitted to the ultimate goals of price stability, production, employment, and external balance (CBN, 2016). The various intermediate channels by which changes in the nominal money stock or short term interest rates influence macroeconomic aggregates are referred to as the monetary policy transmission mechanism (Akani, 2013). The interest rate channel explains the relationship between expansionary monetary policy and lower long-term interest rates, which affects business investment, residential housing investment, and consumer spending on durable goods, and the asset price channel explains the relationship between asset prices and consumer spending on durable goods. The exchange rate channel showed that an expansionary monetary policy lowers the domestic real interest rate and, through the foreign interest parity situation, causes a real depreciation of the domestic currency, according to those who believe that expansionary monetary policy contributes to higher share prices, which makes investment more appealing and increases aggregate demand. this results to higher net exports and stronger aggregate demand on the supply side.

When the health of the banking sector deteriorates, monetary policy decisions may have a greater impact. It could be more expensive for banks to collect the additional capital needed to meet regulatory requirements. Furthermore, in economies where banks are not assessed by external rating agencies or where they report less details to the public, the cost of raising new capital may rise even more, as potential bank shareholders may find it more expensive to verify the health of a particular bank. A rise in loan interest rates reflects the higher cost of bank capital, which is then passed on to the cost of foreign borrowing for businesses.

The channels of transmission of monetary policy

In modern financial systems, four channels of monetary policy transmission have been established, according to Kamin et al (1998). The first is by direct interest rate impacts, which influence not only credit costs but also debtor and creditor cash flows. Interest rate increases affect the marginal cost of borrowing, affecting spending and saving, and therefore aggregate demand. Borrowers and lenders would also be affected by changes in average interest rates.

The effect of monetary policy on domestic asset prices, such as bond, stock market, and real estate prices, is the second channel. The third route involves the exchange rate. The fourth main channel is credit availability. Interest rates cannot shift to clear the market in countries with underdeveloped or tightly regulated financial markets. The quantity of credit, rather than its price, often influences aggregate demand. Credit reforms, in addition to interest rate changes, have been described as important factors affecting economic activity even in liberalized, highly developed markets. The financial structure and macroeconomic climate of a given economy determine how these channels work. The meeting's main goal was to look into the important ties between financial structure and monetary policy transmission mechanisms.

Factors influencing the transmission of monetary policy

In determining how quickly monetary policy impacts the real economy, two factors are critical. The first is the transmission of central bank-controlled instruments – such as short-term interest rates or reserve requirements – to the variables that have the most direct impact on non-financial sector conditions, such as loan rates, deposit rates, asset prices, and the exchange rate. The relation between financial conditions and household and firm spending decisions is the second aspect of the monetary transmission mechanism. The initial financial position of households, companies, and banks, including the extent of leveraging, the composition and currency denomination of assets and liabilities, and the degree of reliance on external financing sources, especially bank financing, is likely to play a key role in this regard.

Liquidity of capital market

The ease with which shares are exchanged in a stock market is referred to as liquidity (Ifeoluwa and Motilewa, 2015). The ratio of securities exchanged to total national production,

which is calculated as total value traded/GDP, is used to measure liquidity. Liquidity refers to an asset's capacity to be turned into cash at a moment's notice without losing value. Liquidity of the stock market is also one of the regulatory authorities' top priorities in the market. This is because a liquid capital market allows potential investors to change their investments rapidly and cheaply, lowering the risk of their investment and allowing them to invest in more profitable ventures. Investors would be hesitant to tie up their money for an extended period of time in an illiquid stock market (Okonkwo, Ozrouru & Ajudua, 2014).

III. THEORETICAL REVIEW

Monetarist Theory of Monetary Policy

Monetarism is described by Cagan (1989) as a philosophy associated with the belief that the quantity theory of money affects economic activity and price level, and that monetary policy must target the growth of money supply to contain inflation. The Chicago School of Economics was the forerunner of this school of thought, and Milton Friedman, widely regarded as its torchbearer, was later joined by Anne Schwartz. Monetarists emphasize the importance of money and the relationship between money growth and inflation, as the name implies (De Long, 2000). Money inflation in the quantity equation explicitly describes the monetary policy transmission mechanism, as opposed to the indirect relation through financial markets discussed earlier in Keynesian monetary theory. Milton Friedman (1968), the godfather of monetarism, argues in his early works that there are direct evidences that monetary policy has a significant short-term impact on real variables.

Rational Expectations Theory

According to John F. Muth's rational expectations theory, which he proposed in 1960, the actors in an economy will behave in a way that is consistent with what can reasonably be expected in the future. That is, a person will invest and spend money based on what he or she thinks will occur in the future. While this theory has gained a lot of traction among economists and financial analysts, its usefulness is debatable. For example, if an investor believes a stock will rise, he or she may buy it and cause the stock to rise. Outside of reasonable expectations theory, the same transaction can be framed. When an investor recognizes that a stock is undervalued, he or she purchases it and waits for other investors to notice the same thing, causing the price to rise to its true market value. This is the issue with the Nigerian stock market, which has been seeking to regain market trust since the global financial crisis. Nigerian investors' expectations are negative, and the market is lagging as a result, despite the regulatory agency's and the Nigerian stock exchange's innovations.

Empirical Review

Using data from the Nigerian economy from 1980 to 2013, Akani, Okonkwo, and Ibenta (2016) investigated the impact of monetary policy on capital market activities. The empirical

findings show that monetary policy instruments such as the Broad Money Supply (M2), Liquidity Ratio (LIR), and Interest Rate (INTR) have a positive significant impact on Market Capitalization (MC), while the Monetary Policy Rate (MPR) and Treasury Bill Rates (TBR) have a negative and negligible effect on Market Capitalization (MC). Except for the Monetary Policy Rate, the results of model II show that the independent variables have a positive and important relationship with the dependent variables of the All Share Price Index (ASPI) (MPR). Mojo and Peersman (2003) investigate the monetary transmission mechanism in ten Eurozone countries. They assess cross-country transmission mechanism differences using the structural VAR process. Variables such as the world commodity price index, US GDP, and short term interest rates were included by Mojo and Peersman. The systemic New Keynesian model with three equations (Output difference, New Keynesian Phillips curve, and monetary policy reaction function) and the SVAR approach are used by Al-Raisi, Pattanaik, and Al-Raisi (2007) to investigate the transmission mechanism in Oman. Both the structural equation model and SVAR produce evidence that indicates interest rate changes have little effect on aggregate demand and supply in Oman. They attributed these findings to the lack of market-determined interest rate responses to Oman's interest rate policy.

Since monetary policy tightening affects bank credit in both supply and demand, Jimenez, Ongena, Peydro, and Saurina (2011) discovered that identifying monetary policy effects through the credit channel is difficult. As a result, various approaches were devised by individual studies to solve this problem; as a result, the results of these models are rarely comparable, but they are still rather insightful. Jimenez, Ongena, Peydro, and Saurina (2011) used the firms' loan applications to assess the impact of monetary policy on the likelihood of a loan being granted. Credit rationing models are another way to investigate the impact of monetary policy on production through the credit channel. Credit rationing models say that when credit market rigidity exceeds a certain amount, monetary policy effects become greater (Shao, 2010). Credit rationing models, on the other hand, have the flaw that the threshold amount is unknown and depends on the sample space in the study; it varies from sample to sample. Using Granger causality, Johansen co-integration, and the Vector Error Correction Model, Akani (2013) investigated the impact of inflation, interest rate, and money supply on aggregate stock prices in Nigeria from 1985 to 2011. Changes in the variables have a major effect on the overall stock price, according to the findings. According to Ho (2006), financial innovations that have an effect on financial market conditions will affect the transmission mechanism. The interest rate channel, asset channel, and exchange rate channel are the three key channels that can influence monetary policy, according to the author. He goes on to say that financial innovation improves the capacity of economic agents to lock in existing interest rates for potential funding needs.

In Macedonia, Fetaj and Izet (2010) looked at the effect of the exchange rate on real GDP and prices. They find that shifts in money stocks and exchange rates have no major effects on real GDP using the SVAR process. Exchange rate shocks, on the other hand, have a big impact on the price level in Macedonia. In Japan, Boivin, Kiley, and Mishkin (2010) used the Vector Error Correction Model (VECM) to investigate the current relationship between stock market return and a collection of macroeconomic variables such as exchange rate, inflation, money supply, industrial output index, long term bond rate, and call money rate. The results showed that a collection of macroeconomic variables is co-integrated with the price of Japanese stocks. When Gerdesmeier (2013) looked at the impact of monetary policy on economic growth in Kenya, he found that the treasury bill rate and required reserve ratio have a positive impact on the cost of credit. In Kenya, the monetary transmission mechanism has a significant impact on credit development, credit cost, and deposit size. According to the author's review, the real money supply, required reserve ratio, and Treasury bill rate are all inversely related. As a result, the researcher concludes that lowering the required reserve ratio, Treasury bill rate, or both would vastly increase the amount of money supply in the economy. The author employed the Structural Vector Autoregressive Model (SVAR) and data from 1997 to 2009.

IV. METHODOLOGY

The type of data used in this research work is the secondary data. The relevant data for the study was obtained from Central Bank of Nigeria (CBN) and Security and Exchange Commission (SEC) for the years under review.

Inferential statistics adopted for the study include Ordinary Least Square (OLS) multiple regression to examine the impact of monetary policy transmission mechanisms on capital market liquidity and Granger causality test was used to determine the direction of causality between the focal variables. The dependent variable is the capital market liquidity proxied by turnover ratio while the independent variables are: asset pricing channel; interest rate channel; credit channel; exchange rate channel and expectations channel to proxied by treasury bill rate, savings rate, net domestic credit, Naira exchange rate per US Dollar and inflation rate respectively

Model Specification

The formulation of this model is based on the empirical review of Musa Al-Faki (2006) and Ogunmuyiwa (2010) who opined that capital market liquidity is denoted by the turnover ratio of the market.

Thus, the model is given as;

$$TOR = f(\beta_1 + \beta_2 + \beta_3 + \beta_4 + \beta_5 + \mu) \dots \dots \dots (1)$$

Hence, the functional relationship is given as;

$$TOR = f(TBR, SR, NDC, EXR, INFR) \dots \dots \dots (2)$$

The logarithmic transformation of equation (2) is designed to bring the variables to the same base, hence the model becomes:

$$TOR = \beta_0 + \beta_1 \text{Log}(TBR) + \beta_2 \text{Log}(SR) + \beta_3 \text{Log}(DC) + \beta_4 \text{Log}(XR) + \beta_5 \text{Log}(NFR) + \mu \dots\dots\dots (3)$$

Where

TOR = Turnover Ratio proxy for Capital Market Liquidity

TBR = Treasury Bill Rate proxy for asset pricing channel

SR = Savings Rate proxy for interest rate channel

NDC = Net Domestic Credit proxy for credit channel

EXR = Naira Exchange Rate per US Dollar proxy for exchange rate channel

INFR = Inflation rate proxy for expectations channel

β_0 = regression constant

$\beta_1 - \beta_5$ = slope coefficients

μ = error term

V. DISCUSSIONS OF RESULTS

Table 4.1 below shows the descriptive statistics of the channels of monetary policy transmission mechanisms which include treasury bill rate, saving rate, exchange rate, net domestic credit and inflation rate. It is revealed in the table that net domestic credit has the maximum value of 8.600 followed by exchange rate (3.566), followed by treasury bill rate (2,213), followed by saving rate (1.695) which is then followed by inflation rate (1.269). The minimum value of all the identified channels is zero (0). The mean and standard deviation of the channels as reported in the analysis are treasury bill rate (1.46, 0.93); saving rate (1.12, 0.714); net domestic credit (6.12, 3.82); exchange rate (2.49, 1.56) and inflation rate (0.97, 0.29).

Table 4.2 below shows the impact of monetary policy transmission mechanism on capital market liquidity. The result shows that all the channels of transmission mechanisms have a positive relationship with Turnover Ratio (TOR) with an exemption of exchange rate. This implies that as treasury bill rate, savings rate, net domestic credit and inflation rate increase, TOR will also increase and that as exchange rate increases, TOR will decrease.

However, of all the channels of monetary policy transmission mechanisms, none is statistically significant at 5% significant level, as they all displayed p-values greater than 0.05. this is however, in dissonance with the findings of Akani and Imegi (2017) who reported that treasury bill rate, monetary policy rate and credit to private sector to GDP have significant effect on capital market liquidity. The R² and adjusted R² of 67.6% and 49.7% indicate that a reasonable number of the variations in the dependent variable are explained by the independent variables. Also, the value of F-Statistic value shows the

overall significance of the model and evaluates the goodness of fit to predict the explanatory power of the model. Hence, the hypothesis that states that monetary policy transmission mechanisms do not affect capital market liquidity is rejected.

Table 4.1: Summary statistics for the key variables over the period 2006-2020

Variables	Mean	Standard Deviation	Minimum	Maximum
Logtor	1.007202	.2101447	.643453	1.531479
Logtbr	1.460296	.9399767	0	2.213836
Logsr	1.123754	.7148862	0	1.695044
Logndc	6.123457	3.826102	0	8.60055
Logner	2.499101	1.564187	0	3.566208
Logir	.9701245	.2940304	0	1.269513

Source: Author’s Research (2020) using STATA 14

Table 4.2: OLS Multiple Regression Summary Results

Dependent variable	Independent variable	Coefficient	Standard Error	T	P> t
TOR	Logtbr	.0067172	.3171058	0.02	0.984
	Logsr	.2109971	.4086318	0.52	0.618
	Logndc	.1418973	.3775899	0.38	0.716
	Logner	-.5434739	.8868861	-0.61	0.555
	Logir	.213193	.2490803	0.86	0.414
	Constant	1.042755	.261346	3.99	0.003
R-Squared = 0.6769	Adjusted R-Squared = 0.4973	Prob > F = 0.0405	F = 3.77		

Source: Author’s Research (2020) using STATA 14

Source	SS	df	MS
Model	.418469176	5	.083693835
Residual	.199782292	9	.022198032
Total	.618251468	15	.044160819

Source: Author’s Research (2020) using STATA 14

VI. CONCLUSION

The effectiveness of monetary policy transmission mechanisms in affecting the liquidity of capital market depends on the state of the financial system, and various financial developments can potentially change the way monetary policy is transmitted through the financial system. From the findings of the research, interest rate, asset pricing, credit availability and expectation channel have positive relationship with capital market liquidity with the exception of exchange rate.

Thus, exchange rate should be worked upon so as to enhance the liquidity of Nigerian capital market in view of its negative impact on the capital market liquidity

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